

Executive summary

With the onset of the current financial crisis, the world has seen an initial unwinding of global imbalances that were built up over the past decade. As the crisis continues to unfold – after years of expansionary monetary policies, financial deregulation and excessive credit utilization – a fundamental question emerges:

How might the governance and structure of the global financial system evolve over both the near-term and long-term?

This report explores this question by describing a range of recent macroeconomic shifts in section one, a near-term outlook (up to 2012) for governance and structure in section two and a long-term view (up to 2020) in section three. The near-term outlook is based on analysis of recent shifts in the financial system that have occurred amid the recent market turmoil. The long-term view is based on scenario thinking – a powerful tool that helps policy-makers and business leaders prepare for a range of possible alternative futures in a world defined by uncertainty.

The future of the global financial system²: A near-term industry outlook

After more than two decades of exceptional growth, financial institutions are adapting to a new environment of tighter credit and slower economic growth, increased government intervention and a threat to the previous pace of globalization.

- **Interventionist regulatory reform:** Global policy-makers have committed to a new regulatory framework that is expected to expand the scope of regulated entities, increase global regulatory coordination and constrain the growth prospects of incumbent financial institutions.
- **Back to basics in banking:** Banks of all types have begun the process of repairing their balance sheets through higher liquidity and capital ratios, coupled with reduced reliance on short-term wholesale funding. Re-regulated banks are likely to become more like utilities as they refocus on core

competencies. Moreover, bank strategies are less likely to overlap as individual competitive advantages are reaffirmed.

- **Restructuring in alternatives:** Alternatives players have suffered in the current financial crisis, from both deleveraging and market turmoil. Recent hedge fund losses have called into question the durability of absolute-return products. Private equity firms have to balance steering levered portfolio companies through a severe downturn with the challenge of raising new capital to pursue upcoming investment opportunities when many among their investor base are severely limited in terms of capacity to commit capital. Meanwhile, many investors are shifting their attention to low-cost indexation strategies and “new beta” asset classes. As a result, “unconstrained” providers of capital – such as family offices and sovereign funds – may gain the upper hand.
- **A tale of two insurers:** The fortunes of the insurance industry are broadly split between property & casualty versus life insurers on the one hand, and North America versus Europe on the other. While some organizations will be forced to focus on survival, many will be able to capitalize on the emergence of new acquisition opportunities, continued demand for retirement products and an increased use of traditional insurance products to hedge risk, thereby strengthening their underlying businesses.

The future of the global financial system: Long-term scenarios

Over the longer term, a range of external forces and critical uncertainties will shape the future of the global financial system. During 2008, the World Economic Forum engaged over 250 financial executives, regulators, policy-makers and senior academics at eight different workshops to develop potential long-term evolutionary scenarios for the global financial system. These scenarios go beyond simply extending current trends and explicitly take into account critical uncertainties, potential discontinuities and system dynamics. These scenarios can be used to support strategic decision-making and facilitate collaborative action.

² The report was originally intended to focus on particular actors within the financial system, the so-called ‘new’ financial powerhouses, but was expanded in light of the ongoing financial crisis. The report covers banking, insurance and alternative investors such as hedge funds and private equity firms, but does not explicitly cover other critical actors such as pension funds and exchanges/OTC markets. These actors will be addressed in the second phase of this project.

In answering the project’s central question, the scenarios vary along two critical uncertainties: the pace of the ongoing geo-economic power shift from today’s advanced economies to the emerging world and the degree of international coordination on financial policy. These critical uncertainties have been defined based on a survey of the World Economic Forum’s industry partners, interviews with leaders in the field, and extensive research. Based on this analysis, four plausible and compelling views emerge about how the global financial system might evolve between now and the year 2020 (Figure 1). Each of these scenarios take a myriad of underlying driving forces into account – such as the evolution of energy and commodity prices, global economic growth, fiscal policies, trade regimes, climate change, exchange rate policies, extremism, demographics and global wealth distribution.

Financial regionalism is a world in which post-crisis blame-shifting and the threat of further economic contagion create three major blocs on trade and financial policy, forcing global companies to construct tripartite strategies to operate globally.

Re-engineered Western-centrism is a highly coordinated and financially homogenous world that has yet to face up to the realities of shifting power and the dangers of regulating for the last crisis rather than the next.

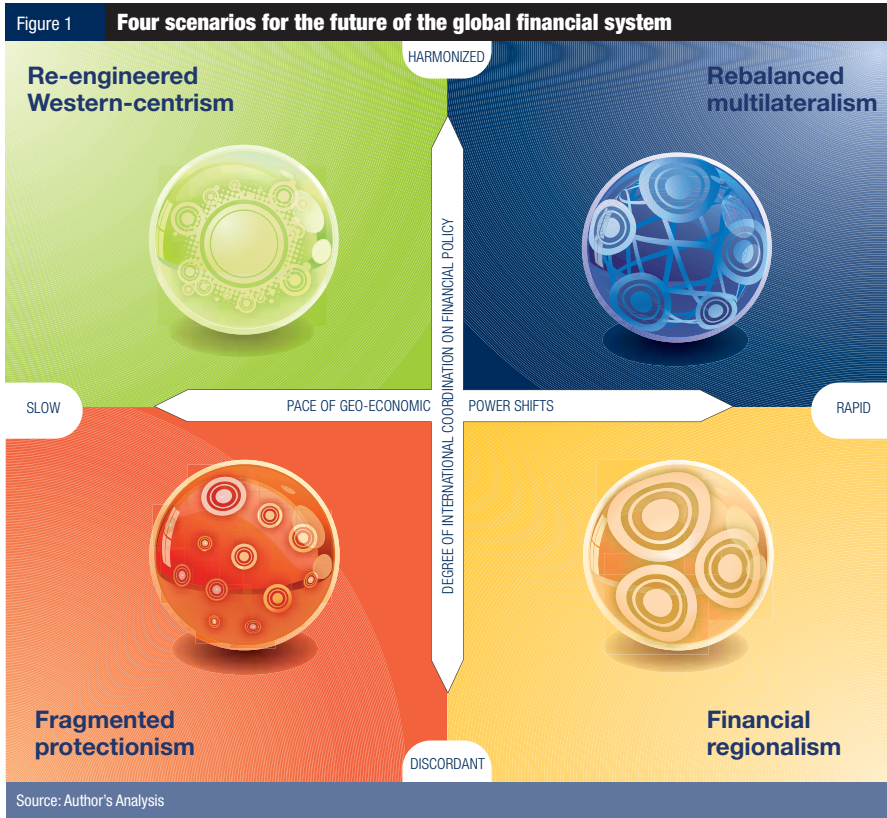
Fragmented protectionism is a world characterized by division, conflict, currency controls and a race-to-the bottom dynamic that only serves to deepen the long-term effects of the financial crisis.

Rebalanced multilateralism is a world in which initial barriers to coordination and disagreement over effective risk management approaches are overcome in the context of rapidly shifting geo-economic power.

Each of these scenarios describes key forces and turning points that could fundamentally shape the governance and structure of the global financial system in the next decade. These scenarios are not designed to predict the future, but rather to explore the boundaries of the plausible, to stimulate strategic thinking and facilitate collaborative action between the various stakeholders.

Phase two of the New Financial Architecture project

In phase two, the World Economic Forum aims to build on the insights of this report and explore opportunities for collaboration to help strengthen the global financial system. This will involve an examination of potential future sources of systemic risk as well as opportunities to reposition the industry for sustainable long-term growth, and to ensure economic stability and prosperity of both the financial and real economies. Phase two will also explore strategies at the stakeholder level.



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